ATLANTIC PROVINCES ECONOMIC COUNCIL | CONSEIL ÉCONOMIQUE DES PROVINCES DE L'ATLANTIQUE

Commentary

January 21, 2009

Atlantic Economists Offer Advice on Upcoming Federal Budget

In the wake of political and economic upheaval, there has been an unprecedented round of consultations leading up to the 2009 federal budget. To contribute to the debate, we asked eight of Atlantic Canada's leading economists to step forward and offer their ideas.

Each contributor was asked to respond to the following questions:

1. What is the biggest economic challenge facing Atlantic Canada in the current recession?
2. How severe will the downturn be and how long to you anticipate the recession will last?
3. What are your priorities for a federal stimulus package?

Although perspectives vary on the anticipated duration of recession, this group of economists has no hesitation in recommending that government should ramp up its fiscal policy instruments to provide economic stimulus and reduce the negative effects of the recession.

All contributors agree on the importance of initiatives to encourage consumer spending. However, they express little confidence that income tax reductions will achieve this goal. Instead, the economists recommend measures that will lead to direct spending, such as increasing benefits through the Employment Insurance and Guaranteed Income Supplement programs, providing one-time cash transfers and increasing tax credits.

On the types of infrastructure spending that might merit support there is considerable diversity of opinion, with some preferring more traditional spending on roads and other transportation initiatives, and others recommending knowledge and social infrastructure. The contributors do make a strong case for choosing projects which will enhance productivity over the long run, rather than responding to short-run pressures. There is also clear consensus on the need to implement selective projects quickly, taking advantage of lower costs and ensuring that projects will be complete before the economy rebounds.

Along with our contribution, these submissions offer unique perspectives on the recession, the merits of government intervention and priorities for action. I want to thank all the contributors for their thoughtful and timely response.

Elizabeth Beale
APEC President & CEO

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4. **Fred Morley**, Greater Halifax Partnership
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Elizabeth Beale, President and CEO, Atlantic Provinces Economic Council

Less than three months ago, APEC was cautiously optimistic that the recession would be short and relatively shallow. How quickly conditions have changed! The global economy is now expected to experience the deepest recession in the last half-century. Most forecasters are revising their outlook for the Canadian economy downwards, a consequence of continued weakness in commodity prices, on-going difficulties in credit markets and accelerating job losses in manufacturing.

Though Atlantic Canada was slow to enter the recession, our deteriorating economy is now becoming more evident. Retail spending has dropped and consumer bankruptcy rates have jumped up in the three Maritime provinces. The decline in output and exports from some key industries is now leading to job losses: employment dropped by about 9,000 across the region in the last two months. The Atlantic economy is unlikely to experience the same job losses on a proportional basis as Ontario. Nevertheless, the worsening economic downturn will hurt businesses and individuals across the region this year.

With the economy expected to continue to contract through the first half of 2009, any optimism about a return to growth in the latter part of this year hinges on one's expectations about the success of economic stimulus packages in Canada and the U.S. What priorities should be addressed in the Canadian budget to help our economy get back on track[1]?

The most immediate challenge is to rebuild confidence and encourage consumers to spend. One of the most effective ways to do this is by increasing cash transfers to low and middle income Canadians -- they are the ones who are most vulnerable in an economic downturn, and also most likely to spend the support they receive quickly. A program which already has broad coverage and could be readily adapted for a quick response is the federal GST/HST tax credit which currently provides a maximum credit to single adults of $369/year. Increasing this by a minimum of 35%, making this a monthly rather than quarterly payment, would provide timely support to a large number of Canadians.

Another target should be to increase the commitment to training under the EI program. Changes could include: funding training that is more than a year in length; providing support for part-time and on-the-job training; ensuring access to training for those who are underemployed; and placing greater emphasis on prior learning assessment and customized training for older workers. These measures could help ensure that firms will have access to appropriately skilled workers when the economy rebounds.

A third priority is new funding for infrastructure, with transportation at the top of the list. High transportation costs consistently rank at the top of business concerns in Atlantic Canada, and projects that will improve the flow of goods and services across provinces such as twinning the highway between New Brunswick and Quebec and improvements to Marine Atlantic's North Sydney to Port-aux-Basques ferry service could help to reduce the cost of doing business in Atlantic Canada.

[1] For APEC's submission to Finance Minister Flaherty: CLICK HERE

Lars Osberg, Dalhousie University Economics Department

In the last two months of 2008, Canada lost 105,000 jobs and the U.S. lost nearly a million. The economic news in recent months has been unrelentingly bad and as a result, very few Atlantic Canadians need convincing any more that Canada is headed for a serious recession – it is only incurable optimists who see recovery before 2010-2011.

In job losses, the U.S. has led Canada and Ontario has led Atlantic Canada – but the chill is spreading. Commodity prices have tanked, demand for forest products is slumping, manufacturing employment is down and any good or service (such as tourism) that depends on consumer purchasing power is struggling to stay afloat. And as the unemployment rate rises and rhetoric about "labour market shortages" rapidly fades into yesterday's news, Atlantic Canadians will increasingly come face to face with the holes cut into our national social safety net since 1995. In the country as a whole, only about 38% of the unemployed have been getting Employment Insurance (EI) benefits in recent years. In Atlantic Canada's rural areas the percentage able to claim EI has been significantly higher, but both rural and urban labour markets can expect a wave of applicants for Social Assistance support as families try to cope with no job and no EI.

In the recessions of the early 1980s and early 1990s, Canada's Unemployment Insurance system reached over 85% of the unemployed, and UI benefits were higher and lasted for longer. Under the Canada Assistance Plan, the federal government then shared the cost of Social Assistance with provinces. However, the shift to block grants in the mid-1990s means that in this recession, Atlantic Canada's people and governments will be on their own. The dramatic recent tumble in the price of oil means that Newfoundland's reversal of fortunes will be especially severe, but all the Atlantic provinces can expect turnarounds in their budget balances. In this environment, government deficits are unavoidable – the only question is how much stimulus expenditure to add to the inevitable safety net expenditures which the recession is bringing.

Deferred maintenance in our universities, wind farms for our future renewable energy needs, social housing for the homeless, transit systems for both urban and rural areas – Atlantic Canada has many needs. All of them would produce long term benefits, but which is the best place to spend in order to stimulate a recovery? In making these calculations, governments should recognize that the social opportunity cost of unemployed labour is close to zero. Unemployment is a total waste of potential economic output. Whether or not a particular stimulus programme, in some objective sense, is absolutely optimal in design, it is always better to have some output than none. So we should not dither around and await the perfectly designed programme. And although it's always nice to co-operate with Ottawa, we need not wait for the federal government. We can also be pretty sure that when global growth eventually does resume, energy prices will soar again and we will need renewable energy sources. We know that we have already acquired a substantial social deficit. Now is the time to address these social needs energetically.

Frank Strain, Mount Allison University Economics Department

To contribute to APEC's discussion of the current recession and possible stimulus policies, there are six points I would like to make:

1. ***Canada is not the U.S. and there is no evidence that the fundamental problems affecting the U.S. are issues in Canada*:** Canadian housing prices have not collapsed and we do not have a sub prime issue; Canadian monetary policy is not impotent; our commercial banking system is neither bankrupt nor paralyzed; the value of the Canadian dollar has fallen 20% thus automatically offsetting some of the impact of declining demand for exports; and our government finances are in good shape giving us the flexibility to intervene with expansionary fiscal policy as needed. Nonetheless, the recession has undermined confidence in both countries, and despite fairly strong fundamentals many Canadians seem to believe that Canada is the U.S. and as a consequence have become irrationally afraid. If this fear becomes widespread it will have real economic consequences in Canada.

2. ***Canada will be directly affected by the U.S. recession through lower exports, but the impact of declining exports will be relatively small.*** Even in a worst-case scenario where U.S. imports of Canadian goods and services fall by 20% in response to a 20% decline in U.S. income, Canadian incomes would only decline by 6-10%. The Obama government plans to implement an aggressive fiscal stimulus plan over the coming two years, which, if successful would raise U.S. incomes and help restore Canadian exports.

3. ***Lessons from the Great Depression*** If we experienced a decline in income of 25%, average incomes would be back to levels of the early 1990s. The 25% decline of the 1930s had a dramatic impact on living standards because incomes were already low, but a 25% decline today does not guarantee destitution. Also, the vast majority of people did not experience a 25% decline in income and most of the burden fell on those who could not find employment through no fault of their own.

4. ***The Canadian government should immediately institute a temporary increase of the replacement rate under the Employment Insurance program from its current low level to 75% or more*** This policy has several attractive features: it directly targets those that lose their jobs allowing them to sustain consumption; it eases the fears of all and reduces precautionary saving while bolstering business confidence; the size of stimulus would be determined by the severity of the recession; the impact would be felt immediately (no time lags); and the stimulus would be spread across industries according to consumer spending patterns and would closely mirror the pattern of spending declines.

5. ***There are a large number of infrastructure projects that meet cost/benefit tests and they should be undertaken immediately regardless of economic conditions*** With the increase in saving, the flight to safety, and the decline in business investment, interest rates on government bonds are very low. Moreover, any excess capacity in the construction industry should show up as lower prices in the tendering process. Thus infrastructure projects undertaken now will be less expensive than they would be if undertaken later.

6. ***Bolster the GIS to help Canadians facing retirement*** Those who are retired or are about to retire are most acutely feeling the immediate impact of the past year's staggering loss of wealth and many face extreme poverty. This could be addressed by strengthening the Guaranteed Income Supplement (GIS).

Fred Morley, Chief Economist, Greater Halifax Partnership

When my mother was growing up in Cape Breton during the Great Depression governments were quite unsophisticated in their approach to the economic downturn. Since government could not temper the effects of economic downturn, my grandfather's response came in the form of a barrel of mackerel from Main-à-Dieu in the cellar and sacks of blue potatoes from Grand Mira in the pantry. Hopefully times have changed.

We now know that countries, communities and their companies can greatly influence how deeply a recession affects them. Attitude is important and predictions of doom and gloom can be self-fulfilling. However, companies and communities that face the turmoil with a realistic but positive attitude recover earlier and prosper sooner. And so Halifax will dodge some of the worst effects of this economic storm, partly because of our very stable economic structure and partly because of our confidence in the future.

Housing construction across the Atlantic region is slowing after a few very hot years but growing population and household formation in key urban centres will encourage some developers to keep building. The recession in the U.S. is already reducing demand for products from our resource industries while tourism numbers continue to decline in areas outside major centres. Halifax will feel this pain too in the form of fewer shipments through our port, less work for our business services sector and in other ways.

If government takes thoughtful and specific actions in its approach to the recession we will weather it well and move to growth towards the end of this year. However, if government avoids tackling the crisis head-on, as it did in last year's financial update, we will be waiting a lot longer for the economy to thaw. The deepest recession in three generations needs the correct fiscal response. Here are some ideas:

1. ***Do no harm*** Cutting government spending to address a recession is like hosing down a leaky roof in a rainstorm. Permanent tax cuts that flow to savings and debt reduction and not to real-time consumer spending will fail as stimulus and make getting out of deficit harder.

2. ***Spend on the right infrastructure*** Projects that leverage spending at every level of government should be a first priority. Good infrastructure investment doesn't always mean using the maximum amount of asphalt and concrete. Governments must pursue projects that have lasting impacts on our competitiveness, such as investments in higher education, innovation and research and development. The state of urban infrastructure is affecting our nation's productivity. If we want to come out of this recession strong, Canada's urban infrastructure deficit needs to be addressed.

3. ***Work to stimulate consumption*** This means getting money into the hands of people that will spend it now. Government should consider shortening waiting times for employment insurance, using one-time tax credits for lower income Canadians or enhancements to the GST rebate.

4. ***Governments must recognize that business and consumer confidence is a fragile thing*** People are looking for thoughtful fiscal policy responses that will shorten the economic downturn and lessen its severity, which the federal government's coming budget will hopefully provide. If not, pickled mackerel is still sold by the barrel in Main-à-Dieu and blue potatoes still grow in Grand Mira. I checked.

Wade Locke and Scott Lynch, Memorial University Economics Department

Depressed commodity prices continuing throughout the year and longer would have a disastrous impact for Newfoundland and Labrador from a fiscal perspective and for the continuation and expansion of major resource projects within the province. A continuation of the existing tight credit market conditions will adversely impact small export firms and fishing enterprises and will be felt disproportionately in rural parts of the province.

If the U.S. economy continues to lose jobs as it did last quarter, then real GDP would decrease by 5% on an annual basis, which would produce a significant deep and prolonged recession. Forecasts of U.S. growth at -2.5 to -3% with recovery in late 2009 assumes that the Obama stimulus package removes deflationary expectations and returns the economy to its trend growth rate. For this optimistic scenario (successful stimulus and late 2009 recovery) Canada could experience a 1 to 2.5% decrease in real GDP, with the earliest recovery in September/October.

However, should the U.S. recession reflect the 5% decline in real GDP then Canada, as a small open economy, will follow the U.S. and be faced with a significant period of rising unemployment and declining economic activity, with recovery occurring in 2010. If, on the other hand, the recession in the U.S. is closer to the pessimistic scenario, then this may produce a decoupling of the Canadian/U.S. trade relationship and in that case, predicting possible outcomes becomes very murky.

The items that we might consider for the stimulus package/budget are:

a) ***Speed up and lengthen Employment Insurance benefits*** Employment Insurance provides temporary financial assistance for unemployed Canadians while they look for work or upgrade their skills. In the midst of this economic downturn many Canadians will become unemployed and may require additional weeks of employment insurance benefits. This is particularly true if new projects or programs have to be designed and implemented. As a temporary measure, consideration should be given to removing the two-week waiting period and to increasing the maximum benefit period from 45 weeks to 64 weeks.

b) ***Split marine infrastructure expenditure geographically*** Splitting marine infrastructure spending between western and eastern provinces would have the advantage of being quickly implemented and spread throughout the country, ensuring that capacity constraints do not limit its effectiveness as a stimulus instrument. Such expenditures could include: (1) the Joint Supply Ships contract, (2) the eight Polar Class 5 Arctic Offshore Patrol vessels and (3) ships to upgrade the coast guard mid-shore patrol fleet.

c) ***Support the Lower Churchill energy corridor*** An energy corridor through either the Maritimes or Quebec would help Canada deal with its pressing energy needs while simultaneously taking meaningful steps toward dealing with greenhouse gas problems and giving a boost to the engineering sector immediately.

d) ***Implement a massive training program to prepare for the inevitable labour shortage*** A labour shortage will re-emerge post-economic recovery and training to address this could take the form of labour force training vouchers that could be applied against tuition at any post-secondary educational institution. It would remove people immediately from the ranks of the unemployed, provide income support and increase Canada's productive capacity for the future.

e) ***Offer a payroll subsidy to stimulate employment*** A payroll subsidy from the government would have to be limited in time: if people are not hired by a certain time, then the company would not eligible for the subsidy. To be effective, this measure must be accompanied with a reduction in the GST on a broad basis or a targeted reduction in the consumption tax on big ticket items such as cars and appliances.

f) ***Construct social housing throughout Canada*** Constructing social housing would: be relatively easy to implement; have a significant stimulus impact; address a pressing social need; and benefit the construction industry, which is adversely affected by the current recession.

g) ***Boost spending on post-secondary education infrastructure*** A forward-looking initiative would be to increase post-secondary education infrastructure spending suggested by the AUCC to fix aging PSE infrastructure.

Pierre-Marcel Desjardins, Université de Moncton Economics Department

The question is not whether Atlantic Canada is going to feel the wrath of the economic slowdown suffered by most western economies. The question is how the economic downturn will impact the region and what can be done to minimise this impact. The present crisis has the notable characteristic of not only being an economic crisis, but also a financial crisis.

While Canada's financial sector is faring much better than the American financial sector, the principal challenge for both Canada and the Atlantic region is specifically to make sure that the financial system continues to play its essential role and that businesses and individuals continue to have access – when it is deserved – to funds that they wish to borrow.

It is very difficult to predict how long the recession will last, principally because improvement will be required on two fronts: 1) consumption will have to increase; and 2) the financial sector, particularly in the United States, will have to improve. The fundamental element will thus be a return confidence amongst the various actors, something which is very difficult to predict.

In such an environment, federal and provincial governments are justified to run budget deficits to stimulate the economy, reduce the negative impacts of the recession and contribute to the return of economic growth. Measures taken by the federal government should include three principal measures.

1) ***A strategy to make sure deserving businesses and individuals have access to credit*** A loan guarantee program, where risk is shared between government and financial institutions should be considered.

2) ***An infrastructure program is appropriate*** That being said, not just any infrastructure project should receive government funding, but the government should be selective about which projects it funds. The objective should be to move up the starting dates of projects which would have gone ahead independently of the current economic conditions, or which will contribute to improving Canada's productivity.

3) ***The government should increase Canadian consumers' purchasing power*** However, income tax reductions are probably not the best mechanism to reach this goal. The danger is that such a reduction will generate structural deficits in the future, or delay the return to balanced budgets once the economy is better. We must learn from the mistakes of the Bush and Reagan administrations in the U.S. The measure should thus be a one-time transfer of $400 to every Canadian. This would have the additional advantage of being more progressive than income tax reductions, which would favour wealthy individuals.

Michael Foster, President, Canmac Economics Ltd.

Economies have a tendency to be cyclical – high growth periods and negative growth periods. When the economy enters a recession governments can often provide a fiscal stimulus to dampen the recession's impact on employment and income. The current recession promises to be extended and deep. It is the result of three main factors – high oil prices, a cyclical downturn in the housing sector and a financial crisis. Atlantic Canada has experienced recessions from the first two factors. Given the diverse base and small size of the region's manufacturing sector, the first two factors produce somewhat mild recessions. However, the uncertainty of the depth and breadth of the financial crisis is what may lead us to a longer and deeper recession than normal.

The objective of a fiscal stimulus is to provide short term income and employment creation to ease the pain of a recession and to stimulate the economy out of a recession. There is a general consensus on the policy design parameters for good fiscal policy. Fiscal policy should be timely, well-targeted and temporary to ensure it is in place when needed, has maximum impact effect and has been completed by the time the economy is back on track and can sustain itself.

With these principles in mind, Atlantic Canada should focus on projects that can be implemented quickly. Traditionally, this has been construction projects but it could include non-construction projects such as information technology. Well-targeted projects include those with high provincial impact multipliers such as hospitals that were already planned to be built or energy retrofit projects that boost energy efficiency for long term gain. Finally, the fiscal stimulus should be temporary – public construction projects without long term positive benefit-to-cost ratio, e.g. municipal swimming pools leave us with ongoing operation costs after the economy has recovered and serve as a drag on the economy in the long run.

James Sentance, University of Prince Edward Island Economics Department

Though predictions about the current recession are difficult to make, conditions will likely get substantially worse before they get better, largely because the U.S. housing bubble will deflate further and asset values could still erode significantly. On the other hand, significant offsets are already in place for the Canadian economy in the form of lower energy prices and a lower exchange rate, and policy seems to be moving in the U.S. to provide substantial stimulus and to preserve liquidity. I expect these measures will be only partly successful and that the sheer volume of support needed will force a retrenchment well before things return to 'normal', dragging the recession out.

For Atlantic Canada the biggest challenge will be to avoid being ignored. We are not the part of the country being most directly affected by declining demand, nor the part most obviously being hurt by falling oil prices. Aside from tales of woe about lobster markets, there has been little coverage of Atlantic Canadian fallout from the current crisis. But of course there is fallout.

Many of those being laid off in the tar sands and being hit by the downturn in manufacturing in central Canada are, in fact, Atlantic Canadians who are starting to return to the region, incomes diminished, to add to labour surpluses in local markets. Nova Scotia and Newfoundland are exposed to damage from falling oil prices and revenues. Though Atlantic region businesses are smaller, their exposure to the risk of tighter lending conditions is perhaps even greater. While some Atlantic provinces are no longer have-nots, we still tend to have significantly higher provincial debts and are more vulnerable to fallout on provincial finances, both from the recession and potentially from federal moves.

There is a real danger that the federal government will respond more actively to the bigger, more obvious problems (the banks, the auto industry, the tar sands, BC forestry) or with policy moves that will favor other regions (loosening up on employment insurance eligibility) while ignoring our smaller scale but equally pressing problems.

So what should the federal government do? In the most general sense, keep the money flowing and keep lending going, preferably using lending guarantees rather than direct lending or bailouts. This should be applied in a way that would work at a small scale – say for farmers and fishers – not just for giant auto companies.

The government should also keep spending, preferably in the domestic economy where it can circulate further. This implies either spending money themselves or giving it to those who will spend rather than save. Infrastructure spending is easy to recommend, with the added bonus that we arguably have a significant infrastructure problem. Putting money in the hands of those who would spend it suggests targeted tax cuts or transfers to those with lower or interrupted incomes. A number of good ideas have been proposed here, from opening up EI eligibility to increasing GST rebates or child tax credits, to ensuring that Federal transfers provide sufficient funds for provinces to meet any surge in social assistance payments. Finally, I also think it's important that we recognize and encourage the opportunity that depressed labour markets present for individuals to retrain or go back to school. While the funding of training has been the subject of some discussion, I think it's worth pushing the need to fund a likely surge in post-secondary enrolment, in particular as current federal funding arrangements continue to bundle funds for post-secondary education in with social programs under the Canada Social Transfer.

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